



MULTISTATE TAX COMMISSION

Maximizing the synergies of multi-state tax cooperation

To: Members, Uniformity Subcommittee on Income and Franchise Tax
From: Ken Beier
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Subject: Sourcing of Sales of Electricity

I. Introduction and Summary

Restructuring of the electric power industry in the U.S. since the late 1970s has introduced substantial competition into wholesale and retail markets and created challenges to most types of state taxes, e.g., property, gross receipts, net income and sales and use taxes. The focus of the potential project before the MTC Uniformity Subcommittee on Income and Franchise Tax is the sourcing of sales of electricity and related services. This project, if undertaken, could involve:

- An educational segment, so that participants have a clear understanding of electricity market participants and relationships
- Review of the NESTOA proposal and state regulations (e.g., Massachusetts and Oregon), including those for sales of natural gas
- Development of policy options
- Drafting uniform sourcing rules for typical retail and wholesale transactions.

Significantly, in the drafter's comments to the original UDITPA, it was contemplated that regulated utilities would not be subject to the Act's apportionment provisions. Very few states, however, have adopted special industry apportionment regulations for the electric industry.

II. Electric Industry Restructuring

Some background on the electric industry, including recent federal and state legislative and regulatory activities, is helpful for understanding recent changes in state utility taxation. Electric utilities include state-regulated investor-owned utilities; federal utilities (e.g., the Tennessee Valley Authority (TVA) and the Bonneville Power Administration (BPA)); other publicly-owned utilities (e.g., municipals, public power districts, and irrigation districts); and cooperatively-owned utilities. Since the late 1970s, the federal government has taken steps to open competition for electric supply on the wholesale level, by requiring utilities to purchase power from independent generators (Public Utility Regulatory Policies Act of 1978) and requiring utilities to transport power on an open and nondiscriminatory basis (Federal Energy Regulatory Commission Orders 888 and 889, 1996). As a result, there are now a large number of nonutility power producers that provide electricity to utilities or directly to large commercial and industrial customers.

Since the mid-1990s, several states and the District of Columbia have opened their retail electric markets to competition.¹ This has resulted in the unbundling of electric service into the following elements: generation, transmission, distribution, metering, and billing. Deregulation also involves the breakup of vertically integrated monopolies with defined service areas; however, to a large extent, electric distribution activities continue to be provided by regulated monopolies.

Deregulation of the electric industry has resulted in substantial changes in wholesale markets and in regional power supply pools. Large end-users are, in many circumstances, able to purchase electric power from suppliers, either directly, or through a regional power pool, such as PJM (in the northeastern states) or ISO New England.² Non-utility power producers, which became part of the U.S. electric power system after 1978, accounted for 26.5 percent of net generation of electric power in 2001 and 39.5% in 2012.³

III. State Tax Studies and Regulations Related to Electric Industry Restructuring

a. NESTOA

Recognizing the uniqueness of the energy industry, the North Eastern States Tax Officials Association's (NESTOA) Corporate Tax Working Group formed a subcommittee to develop a model uniform apportionment formula and, if possible, a nexus standard for energy companies that could be adopted by the member states. As stated in the group's final report,⁴ "the use of a uniform approach would minimize the potential for double taxation of income and simplify the administration of income taxation for the industry and the state taxing agencies." Participation in the NESTOA project included industry representatives and the report makes recommendation for sourcing of receipts from the sale of energy for the sales component of a state's apportionment factor.

b. Studies by States and State Organizations

Arkansas, Minnesota, Oklahoma, Pennsylvania, Washington, the Federation of Tax Administrators and the National Conference of State Legislators (NCSL) have undertaken studies of electric industry restructuring and state taxes. (See listing in Bibliography, under state or organizational name.)

¹ There are currently 15 states that provide for a choice of suppliers for retail customers (northeastern states, except Vermont), Ohio, Michigan, Illinois, Oregon and Texas. Seven states—Montana, California, Nevada, Arizona, New Mexico, Arkansas, and Virginia have suspended retail choice. The remaining states have not undertaken deregulation of their electric industry or provided for retail choice. (Energy Information Agency map, as of September 2010.

http://www.eia.gov/electricity/policies/restructuring/restructure_elect.html). (last visited February 24, 2014)

² An overview of regional power markets can be found at <http://www.ferc.gov/market-oversight/mkt-electric/overview.asp> (last visited on February 24, 2014)

³ Energy Information Agency, Electric Power Annual, 2012 and historical tables. <http://www.eia.gov/electricity/annual/> (last visited on February 24, 2014)

⁴ Report to Commissioners & Directors of Revenue, Income Taxation of Energy Companies in NESTOA States, 2 January 2001, North Eastern State Tax Officials Association, Corporate Tax Working Group Subcommittee On Income Taxation Of Energy Companies.

c. State Regulations

Massachusetts has adopted 830 CMR 63.38.10 which explains the allocation and apportionment of income derived from sales of electricity and unforced capacity and from ancillary, transmission and distribution services.

Ohio, while it does not have a corporate income tax, assigns sales of electricity under the Ohio Commercial Activity Tax are sourced to Ohio to the extent that the electricity is consumed in Ohio. See Ohio Rev. Code Ann. § 5751.033 and § 5733.059.

Oregon has also adopted some basic electricity sourcing rules, treating electricity as tangible personal property subject to a “transfer point” destination test (but not “ultimate” destination). See Oregon Administrative Rules, Section 314 150-314.554(2)-9C) for the application of Oregon statutes to sourcing of sales of electricity.

http://arcweb.sos.state.or.us/pages/rules/oars_100/oar_150/150_314.html (last checked on February 27, 2014); But see: *PowerEx Corp. v. DOR*, 2012 Tax Court, *below*).

d. MTC Deregulation Project

The MTC Deregulation, Industry Change and Taxation Project was established with the support of 11 states in fiscal year 1999 to provide research and technical assistance to states and support the exchange of information on tax changes arising from industry restructuring. The project supported a range of research, policy and educational efforts aimed at increasing the understanding of industry issues among state tax personnel. The initial focus of the project was on electric utility restructuring; however, with the passage of Gramm-Leach-Bliley Act (PL 106-102) in 1999, the project broadened its focus to include financial services issues. Telecommunications issues were also included in a survey of the application of telecommunications taxes to cable modem and DSL services. Four seminars on industry restructuring and state tax issues were presented in December 2000, May 2001, March 2002 and March 2003. At the conclusion of this project, state representatives expressed interest in developing sourcing rules for income taxation of energy companies; however, this subject was not formally pursued by the states through the activities of the MTC.

IV. Characterization of Electricity for Income Tax Purposes

While most of the states characterize electricity as tangible personal property, several states consider it to be a service and several consider it to be intangible property.⁵ Thus, it is possible that the income of interstate electrical sellers could be subject to double taxation or be subject to under-taxation.

⁵ See Multistate Corporate Tax Guide (Healy and Schadewald), Sales of Electricity, CCH, Wolters Kluwer.

V. Administrative and Court Decisions Regarding Apportionment of Income from Electricity and Related Services

In re PacifiCorp, 2002 Cal. Tax LEXIS 469 (SBE Sept. 12, 2002)

In its decision, the State Board of Equalization states “Because we conclude that sales of the generation and transmission of electricity here were sales of services performed for the most part outside of California, we further conclude that those sales were sales of “other than tangible personal property” and were properly excluded from the numerator of appellant’s sales factor. Therefore, based upon the foregoing discussion, we conclude that, for purposes of California tax law, electricity is intangible.

<http://www.boe.ca.gov/legal/pdf/02-sbe-005.pdf> (last checked on February 27, 2014)

Powerex Corp. v. Department of Revenue, Oregon Tax Court, NO. TC 4800, Sep. 17, 2012

The Oregon Tax Court held that the sale of electricity is a sale other than a sale of tangible personal property for the purpose of corporate income tax apportionment; and applied the cost of performance rule and confirmed that a majority of the costs incurred by the taxpayer in carrying on the income producing activity of its wholesale electricity sales business are incurred in British Columbia. In the natural gas aspect of the case, the court found that the taxpayer appropriately sources the sale to the ultimate destination rather than the initial point of delivery in Oregon.

[http://www.ojd.state.or.us/tax/taxdocs.nsf/\(\\$All\)/6ADBD15FC3D55A2C88257A7C0064EFAF/\\$File/Powerex4800Opinion091712.pdf](http://www.ojd.state.or.us/tax/taxdocs.nsf/($All)/6ADBD15FC3D55A2C88257A7C0064EFAF/$File/Powerex4800Opinion091712.pdf) (last checked on February 27, 2014)

See also Oregon Administrative Rules, Section 314 150-314.554(2)-9C) for the application of Oregon statutes to sourcing of sales of electricity.

http://arcweb.sos.state.or.us/pages/rules/oars_100/oar_150/150_314.html (last checked on February 27, 2014)

Commentary on the case can also be found in Oregon Tax Court Rules on Apportionment Treatment of Receipts from Electricity and Natural Gas, Grant Thornton State and Local Tax Alert, October 17, 2012.

http://www.grantthornton.com/staticfiles/GTCom/Tax/SALT_Alert_files/OR_apportion_receipts_SALT_Alert.pdf (last checked on February 24, 2014)

EUA Ocean State Corporation, et al. v. Commissioner of Revenue [Nos. C258405-406, C258424-425, C258882-883, C259158-159, C259653, and C262566-568 (Mass. App. Tax Bd., April 24, 2006)], the Massachusetts Appellate Tax Board concluded that electricity was similar to heat, light and sound. As such, it was not tangible personal property for corporate income tax purposes, and should be sourced using the cost of performance rule. [See also Technical Information Release 06-9 (Mass. Dept. of Rev., June 12, 2006).] www.mass.gov/anf/docs/atb/2006/06p240.doc.

VI. Income Tax Considerations for a Uniformity Project

While there are numerous income tax issues related to corporate income taxes on sales of electricity and related services, including nexus, the sourcing of property, the sourcing of payroll, and the applicability of P.L. 86-272, the main focus of a uniformity projection would, most likely, be on the assignment of sales from distribution, metering, billing, transmission, appliance repair, retail sales of electricity and wholesale sales of electricity. In addition to sales of electricity and related services, there are also substantial sales of energy futures (for delivery at a certain date) on commodity

markets, e.g., the New York Mercantile Exchange, and substantial sales of energy derivatives. The development of a model rule could consider its application to these activities. State tax treatment of sales of natural gas may also suggest some possible approaches for sourcing of sales of electricity, and could be reviewed as part of a uniformity project.

Annotated Bibliography

Arkansas Department of Finance and Administration and Tax Division of the Arkansas Public Service Commission, A Joint Study of the Financial Impact of Retail Open Access Among Sellers of Electricity Upon Cities, Counties, School Districts, and State Governments—A Report to the Arkansas General Assembly and the Arkansas Public Service Commission as Required by Act 1556 of 1999.

Energy Information Agency, Electric Power Annual
<http://www.eia.gov/electricity/annual/> (last checked on February 24, 2014)

This report provides statistical information regarding the domestic electric utility industry for the most recent year available. Data on retail sales of electricity and average revenue per kilowatt-hour are presented together with some information on wholesale markets and prices. This is also the starting point for queries of historical data from 2001 to the present.

Energy Information Agency, Glossary of Terms
<http://www.eia.gov/tools/glossary/> (last checked on February 24, 2014)

Federation of Tax Administrators, Electric Utility Taxation under Deregulation, Research Report No. 148. Washington, DC, December 1998.

Following background information on utility deregulation and state taxes, this report presents a state by state review of utility taxes and deregulation activity. The author, John Cappellari, presents a novel argument that electricity is a service; thus limiting the reach of states taxes on out-of-state electric suppliers. He also suggests that an energy consumption tax based on kWh as a preferred approach to taxation. This tax would be imposed at the distribution level.

Howe, Edward T. and Reeb, Donald J., "State and Local Electric Utility Taxes: Evolutionary Taxation of a Deregulating Monopoly," *American Journal of Economics and Sociology*, 58(1) (January 1999): 115-128.

The authors review the evolution of major utility taxes, and the implications of deregulation on state and local tax structure. They predict that it will be difficult for states to continue to tax electric utilities as heavily as they have been in the past and that states will need to address equalizing tax burdens between in-state and out-of-state suppliers.

Jess, Margaret, Restructuring Energy Industries: Lessons from Natural Gas (Natural Gas Monthly Special Report), Washington, DC, U.S. Department of Energy, DOE/EIA,
http://www.eia.gov/pub/oil_gas/natural_gas/feature_articles/1997/restructuring_energy_industries_lessons/html/peg.html (last checked on February 24, 2014)

Good review of similarities and differences between gas industry restructuring and more recent deregulation of electricity. It points out the technology differences between gas and electricity, such as the ability to compress and store gas. Differences in industry structure are also summarized. The report also examines stranded costs, which in gas, took the form of take-or-pay contracts.

KPMG, “States Struggle With Electric Utility Deregulation and the Tax Implications for Out-of-State Marketers,” State and Local Taxation Perspectives, January-February 1999.

Brief review of electric deregulation and its effect on state tax jurisdiction. Suggests that there are constitutional issues with state licensing requirements, for retail electric suppliers, that include payment of taxes by out-of-state vendors. Includes discussion of the general rules for sourcing of sales of tangible personal property and services. It concludes that . . . “until guidance is forthcoming from the states, the sourcing of these transactions will likely remain uncertain.”

Kramer, Andrea, Biek, John, and Lee, David, Energy Derivatives through Federal and State Tax Glasses, Journal of Taxation of Financial Products, 6:3 2007, page 15.

Massachusetts Regulations on Apportionment of Income of Electric Industry, 830 CMR 63.38.10 <http://www.mass.gov/dor/businesses/help-and-resources/legal-library/regulations/63-00-taxation-of-corporations/830-cmr-633810-apportionment-of-income-of.html> (last checked on February 27, 2014)

Mines, Paull, Considering Constitutional Nexus in the Context of Deregulated Electricity—a Case Study, FTA Annual Meeting, May 29, 2001.

Minnesota House of Representatives, Research Department, Electric Utilities: Taxation and Retail Restructuring, May 2000.

Based on responses from 29 states, the report describes taxes on electric utility property in Minnesota, and compares property, gross receipts, sales and use, and income taxes across these states.

National Conference of State Legislatures (NCSL), 7700 East First Place, Denver, Colorado 80230, 303-624-5400. State Taxation in a Changing U.S. Electric Power System (2004)

The Multistate Tax Commission participated in this study, which reviews the range of taxes that affect the U.S. electric system and tax-related issues that arise with restructuring of the industry. Previously, NCSL published “Tax Implications of Electric Industry Restructuring” (1997) and “Restructuring Electric Utilities Series” (1996-1998)

Oklahoma Joint Electric Utility Task-Force: Revenue & Taxation Working Group, Final Report: Study of Impact of Restructuring on Tax Revenues (August 5, 1999)

Oregon Administrative Rules, Section 314, 150-314.554(2)-9C)

http://arcweb.sos.state.or.us/pages/rules/oars_100/oar_150/150_314.html (last checked on February 27, 2014)(regulation found about 2/3rds of the way in).

Treats electricity as sale of a tangible, sourced to state where “delivery” occurs via contract, even if ultimate destination is elsewhere.

Overbye, Thomas J., Reengineering the Electric Grid: Deregulation Places New Demands on the World's Largest Engineered Structure-and Presents New Opportunities for Educated Consumers, *American Scientist*, May-June 2000, pp. 220-229.

<http://www.americanscientist.org/issues/feature/2000/3/reengineering-the-electric-grid> (last checked on February 24, 2014)

The article explains the development of electric power technology and regulated monopoly utilities, the introduction of competitive supply, and the physics of power transfer between utilities.

Pennsylvania Department of Revenue, *Electricity Generation, Customer Choice and Competition: A Report to Governor Ridge and the General Assembly*, August 1, 2000.

Pomp, Richard D. and Oldman, Oliver, *State and Local Taxation*, Revised Third Edition. Hartford: Richard Pomp, 2000.

Chapter 12 of this three-volume work covers the majority opinion in *General Motors Corporation vs. Tracy*, reviews the evolution of the electric utility industry, and the tax consequences accompanying deregulation. In *General Motors versus Tracy*, the U.S. Supreme Court held that a state can overcome Commerce Clause challenges to a tax law that may protect its regulated public utilities--if it could express a reasonable basis for the law. GM challenged the application of Ohio sales and use taxes to gas purchases from out-of-state vendors. In-state utilities are not subject to sales and use taxes, but a separate tax regime. The author provides a history of the electric utility industry, including major legislation. The section on tax implications covers all major taxes (property, sales, gross receipts, and corporate income).

Uehling, Robert H. and Stathopoulos, Peter G., *Constitutional Limitations on State and Local Power to Tax a Deregulated Electric Industry*, *State and Local Tax Lawyer*, Vo. 4, page 65

Washington State Department of Revenue, *The Study of Electricity Taxation*. Olympia: December 1, 1999.

The Washington Legislature directed the Department of Revenue to conduct this study, which focuses on "whether the current state and local tax codes efficiently and effectively operate in this new and changing environment." The report includes an overview of Washington taxes and electric utility taxes, a tax equity analysis, and a consideration of options for electric utility taxation.